



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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TL-N-7105-98
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL
ATTN: CC:NER:
FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS
SUBJECT: , TL-N-7105-98

This Field Service Advice responds to your memorandum dated July 1, 1999, in which you requested that we reconsider the Field Service Advice we provided to you in this case on April 29, 1999. This memorandum modifies our prior advice, and, to the extent that our prior advice is not consistent with this advice, it should not be relied upon. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
O =
R =
U =
V =
Date =
Year 1 =

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Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

State =

ISSUE:

Whether, for purposes of computing the net operating loss carryover under I.R.C. § 172(b)(2), taxable income is reduced by the preceding year's net operating loss carryover before the special deduction allowed under I.R.C. § 833(b) is applied.

CONCLUSION:

[REDACTED]

FACTS:

In your memorandum requesting reconsideration, you did not express any disagreement with the facts set forth in our April 29, 1999, Field Service Advice. You also did not set forth any additional facts for us to consider. Accordingly, the facts set forth herein are identical to the facts set forth in our April 29, 1999, memorandum.

Taxpayer is the successor in interest to both O, which did business as R, and U, which did business as V. R and V were consolidated into Taxpayer in a statutory consolidation under State law on Date. Briefly stated, the Taxpayer became a taxable entity in Year 1 following enactment of changes applicable to Blue Cross/Blue Shield organizations in the Tax Reform Act of 1986. R was a Blue Cross organization subject to I.R.C. § 833 and was a member of a life/non-life consolidated group during the tax years at issue. In Year 1 and Year 2, R

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sustained net operating losses which were not utilized in Year 1 or Year 2, producing NOL carryovers to Year 3 through Year 8.

As a Blue Cross/Blue Shield organization, the Taxpayer was entitled to the special deduction provided under I.R.C. § 833(a)(2). In calculating the special deduction on its federal income tax returns for Year 3 through Year 7, Taxpayer determined the taxable income cap of I.R.C. § 833(b)(2) without first taking into account the NOL carryforward from Year 1 and Year 2.

Taxpayer computed gross income and then subtracted only those items permitted to be deducted in computing "separate taxable income" under Treas. Reg. § 1.1502-12. In its calculation of consolidated income, Taxpayer did not include items taken into account in the calculation of consolidated taxable income, namely the NOL, charitable contribution, and dividend received deductions. Taxpayer did, however, include the I.R.C. § 833 special deduction. Taxpayer then added the separate taxable income of the various members. Consolidated net operating losses were reported for Year 3 through Year 6; no taxable income was reported; and thus, the consolidated items, including its consolidated NOL, charitable contribution and dividend received deductions were not utilized for those years.

LAW AND ANALYSIS

Section 63 of the Internal Revenue Code provides that, for purposes of subtitle A, the term "taxable income" generally means gross income minus the deductions allowed by chapter 1 other than the standard deduction. Pursuant to I.R.C. § 172(a), taxpayers are allowed as a deduction for the taxable year an amount equal to the aggregate of the net operating loss carryovers and carrybacks to such year. The term "net operating loss" means the excess of the deductions allowed by chapter 1 over gross income. I.R.C. § 172(c). While I.R.C. § 172(d) provides for specific modifications to deductions for purposes of determining the excess under I.R.C. § 172(c), these modifications are not relevant for purposes of this case.

The entire amount of the net operating loss for any taxable year shall be carried to the earliest of the taxable years to which such loss may be carried. I.R.C. § 172(b)(2). The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. Id. Taxable income for any prior taxable year is computed by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or any year thereafter. I.R.C. § 172(b)(2)(B); *see, also*, Treas. Reg. § 1.172-5(a)(2)(i). Any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income is computed, however, upon the basis of the taxable income, or adjusted gross income, as the case may

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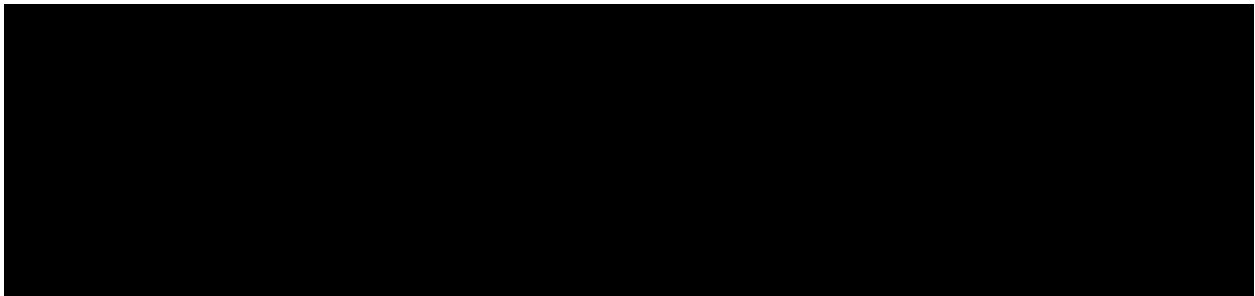
be, determined with regard to any net operating loss carryover or carryback. Treas. Reg. § 1.172-5(a)(2)(ii).

Section 833(a)(1) of the Internal Revenue Code provides that Blue Cross and Blue Shield organizations are taxable as a stock insurance company under Part II of Subchapter L of the Internal Revenue Code. These organizations, however, are entitled to a special deduction as determined under I.R.C. § 833(b). I.R.C. § 833(a)(2).

Pursuant to I.R.C. § 833(b), Blue Cross and Blue Shield organizations generally may deduct, for any taxable year, the excess of 25 percent of the sum of the claims and liabilities incurred during the taxable year under cost-plus contracts and the expenses incurred with respect to the administration, adjustment, or settlement of claims in connection with cost-plus contracts over the adjusted surplus as of the beginning of the taxable year. For the organization's first taxable year beginning after December 31, 1986, the adjusted surplus is the excess of its total assets over total liabilities as shown on its annual statement for such time. I.R.C. § 833(b)(3)(B). surplus as of such time. For subsequent years, the adjusted surplus of a Blue Cross and Blue Shield organization is the adjusted surplus as of the beginning of the preceding taxable year increased by the organization's adjusted taxable income for the preceding year or decreased by the organization's adjusted net operating loss for the preceding year. I.R.C. § 833(b)(3)(A). For purposes of computing the special deduction, adjusted taxable income is taxable income determined without regard to the special deduction or any carryforward or carryback to such taxable year and by increasing gross income by an amount equal to the net exempt income for the taxable year. I.R.C. § 833(b)(3)(C). Adjusted net operating loss means the organization's net operating loss for any taxable year determined with the adjustments set forth in I.R.C. § 833(b)(3)(C). I.R.C. § 833(b)(3)(D).

The special deduction allowed under I.R.C. § 833(a)(2) may not exceed the organization's taxable income for the year determined without regard to the special deduction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



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[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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We accordingly recommend that Examination not pursue the issue further.

If you have any further questions, please call the division telephone number.

cc: Michael Corrado
Assistant Regional Counsel (Tax Litigation)
Northeast Region